Extending the Strategic Sourcing Decision

IN THIS ARTICLE A FRAMEWORK FOR DERIVING SOURCING DECISIONS IS PRESENTED. THE CLASSICAL MAKE OR BUY DECISION IS EX-TENDED BY THREE ADDITIONAL STRATEGIC SOURCING OPTIONS.

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Introduction

Methodological support is needed for the ongoing strategic assessment of the firm to gain an answer to the question how to source an activity. This paper develops a theoretical model based on the resourcebased view (RBV) and Porter's strategic positioning framework (SPF) to guide decision makers whether internal or external production is preferable.
It is shown that future market expectations should be considered in sourcing decisions and that besides the classical "make or buy" alternative, there are three additional sourcing options which should be incorporated. We name these options OFFER, SHARE and SELL and show under which premises the usage of each option is preferable.

We choose the German banking industry as subject for analysis, as this market is currently undergoing severe changes with major players re-focusing their business on core processes and outsourcing non-core areas. Nevertheless, the framework is certainly applicable to other industries as well.

Theoretical foundation

The RBV is predominantly used to explain what functions a company should keep internally or externally. However, the RBV is criticized for not conceptualising the competitive advantage of resources but only the sustainability of competitive advantage. To fill this gap we state in accordance with Porter (1985) that competitive advantage results from cost leadership or differentiation. In the following we develop a framework that integrates Porter's external market view and the internal view of the RBV to explain sustainable competitive advantage.

Barney (1991) introduced the RBV as a framework to evaluate whether the resources of a firm are a source of sustainable competitive advantage. Superior resources are described as being valuable, rare, imperfectly imitable and non-substitutable. Resources are (1) valuable if they lead to increased efficiency or effectiveness, (2) rare if they are not employed by other firms or only by a few firms, (3) not substitutable if there are no alternative resources available in the market that provide the same value as the deployed resource, and (4) imperfectly imitable if competitors are not able to rebuild these resources in a short to medium time period. As stated by Priem and Butler (2001) and agreed by Barney (2001), the fundamental strategy concept of "value" remains outside the resource based view. Only if it is possible to have an advantage in comparison to competitors the word "competitive advantage" can be used and the resources are considered valuable. Porter's view can be utilized to fill this gap. Porter defines two basic types of competitive advantage being differentiation and cost leadership. Competitive advantage through differentiation can be achieved if a company is able to serve specific needs of customers that are not provided by other companies within the industry and for which the customer is willing to pay a premium on the market price. Cost leadership is given if a company has the lowest cost structure to produce a specific business output while achieving at least the same quality than its competitors. These theoretical concepts are now integrated in a common framework to evaluate sourcing options.

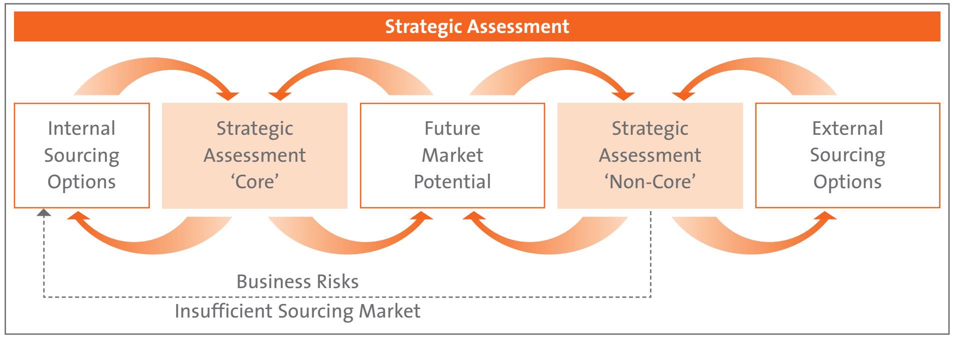

Figure 1: Strategic assessment

The framework

We employ attributes of the RBV as fundamental theoretical basis to identify the company's core. To overcome the deficiencies of the RBV in explaining the attribute "valuable", Porter's SPF is utilized. Therefore the identification of core should be conducted through an assessment of the corporate processes applying the attributes of the combined theories, which leads to a classification of core and non-core processes. A process, which is rare, imperfectly imitable, non-substitutable and provides a cost leadership or differentiates from competitors will be classified as core process. All other processes are preliminary non-core processes.

Starting with this static classification a thorough strategic assessment of the process with regard to the future development (mainly of external factors like the market) has to be executed.

Based on the outcome of the strategic assessment there may be arguments to also consider a non-core process as valuable. This may be the case if there are potential business opportunities in the near future or the possibility to reconfigure the resources deployed in the non-core activity into a driver towards a cost leadership or differentiator position. Following the strategic assessment, further detailed operational analyses have to be performed, including calculation of business cases, market assessments, etc. This is necessary to gain a thorough understanding of the specific implications of alternative sourcing options.
In this stage valid decisions are MAKE, OFFER, BUY or SELL and additionally SHARE, which are described in the following

Sourcing options
Feeny and Willcocks (1998) state, that it is not possible for a corporation to remain competitive if it dissipates managers attention across diverse markets and activities. They argue for business focus on a small number of core activities, while other activities should be outsourced. In conclusion they argue for two sourcing options (1) in-house production (MAKE) or (2) production by an external supplier (BUY). In addition to these basic options we propose to add the options OFFER, SHARE and SELL. In the following all options will be described and illustrated by examples from the German banking industry.

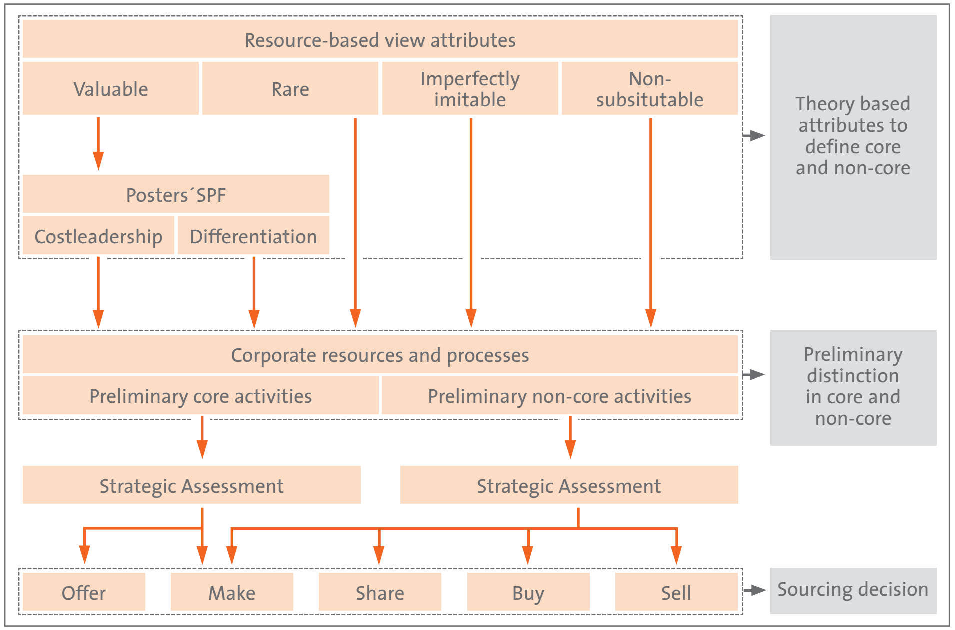

Figure 2: Framework to derive the strategic sourcing decision

MAKE represents the option to internally produce a process which will be utilized within the company only. Thus it represents a process that results into cost leadership or differentiation and the underlying resources are also rare, imperfectly imitable and non-substitutable. Further arguments are needed to explain why the process output shall only be utilized internally and not provided externally: (1) the process generates value which enables the company to significantly differentiate from its competitors. If such a process would be provided to competitors, the potential for differentiation would erode quickly.

Example: Deutsche Börse AG (DBAG) is able to differentiate from its competitors by offering supreme applications that determine prices and quantities for buying and selling financial products. For stock traders it is essential to react quickly to changing markets, subsequently DBAG is able to attract traders by providing excellent software which is developed by superior resources in the process of application development. If DBAG would offer these resources to competitors like London Stock Exchange or other stock exchanges, the source of differentiation would erode quickly. Therefore DBAG produces its trading applications autonomously.

The option to OFFER a process means the process will be produced within the company but also offered to the market, e.g. other banks. This option is chosen if the company is cost leader but the process output is regarded to be a commodity, i.e. has no significant differentiation potential. Thus the process has to fulfil the attributes (a) valuable with the characteristic of cost leadership; (b) rare; (c) imperfectly imitable and (4) non-substitutable.

Example: Deutsche Postbank AG (DPAG) developed a highly standardized and efficient payment transaction system, jointly with SAP. DPAG is Germany's largest retail bank (by number of accounts) with a clear focus on providing efficient services to its 13 million customers. To further utilize their systems, DPAG processes payments for competitors like Deutsche Bank and Dresdner Bank thus achieving economies of scale. As end customers do not regard payments as a process with potential for differentiation, DPAG is able to attract business from other banks without jeopardizing their market position. DPAG itself uses the additional transaction volume to strengthen its position as cost leader in payments services.

The production of a process together with one or more external parties is described as the SHARE option. This sourcing alternative should be applied, when (1) the process does not carry a sustainable competitive advantage, (2) there is no efficient and reliable market to source from and (3) scale economies are a major cost driver. Additional negative impacts on costs have to be taken into account, as sourcing via the market accumulates additional costs for coordination with other partners. Thus the option to share is only valuable if there are economies of scale available which allow the company to pass on increased costs when sourcing via the market (Lammers, 2004).

Example: In the late 1970s German banks decided to issue credit cards as a new service for their customers. As this offering requires extensive upfront investments and all major banks were devoted to offer this service (thus eroding any potential for differentiation), an agreement was reached to jointly produce the credit card process. This led to the formation of the GZS which processes VISA and Mastercard payments and associated services. GZS offers its services generally to all banks in Germany; currently they serve more than 2.300 financial institutions.

The BUY option, the classic outsourcing engagement, should be exercised when (1) external production is more cost effective than internal execution and (2) there is a mature market of service providers for this process. In addition to the strategic assessment, changes in the cost structure of the company have to be considered when sourcing via the market. Especially transaction costs like monitoring, coordination and one-time migration costs have a significant impact on buying a process externally (Poppo and Zenger 1998).

Example: Deutsche Bank decided that the procurement process is not core and therefore should be produced externally. After a market assessment and selection process including several service providers, Accenture was awarded responsibility for the global procurement process.
The option to divest, i.e. to SELL the resources associated to a process and seize production should be taken, whenever the process does (1) generate no sufficient profit and (2) has no strategic and no or just marginal operational value to the company. Furthermore the process may not be valuable with regard to cost leadership or differentiation. Thus if the process is not operationally necessary and does not provide any value the other attributes of the RBV do not have to be checked and the process should be divested.

Example: In its constant assessment of core and non-core processes, Deutsche Bank decided to divest its global custody business as it was not expected to gain a satisfying market position in the foreseeable future. This process was of minor strategic importance and the profits did not meet corporate requirements, so the decision to seize production has been made. Other business units that still need custody services to provide their own services buy these from the outsourcing service provider now.

Conclusion
From a theoretical point of view, we have shown that "valuable" within the RBV can be more precisely described by utilizing Porters SPF, indicating the demand for a process and the underlying resources to result into cost leadership or the ability to differentiate the company from its competitors. By integrating both theories it is possible to identify core processes, i.e. processes which provide a lasting competitive advantage and non-core processes. Furthermore we extended the classical MAKE or BUY decision by introducing and defining when the additional sourcing options SHARE, OFFER and SELL should be taken. For practitioners' we provide guidance for clustering the corporate processes towards preferred sourcing modes, to improve the efficiency of corporate value generation.
However, the strategic assessment needs to be regarded as an ongoing activity and be treated as the most important selection mechanism to assess the strategic sourcing decision.

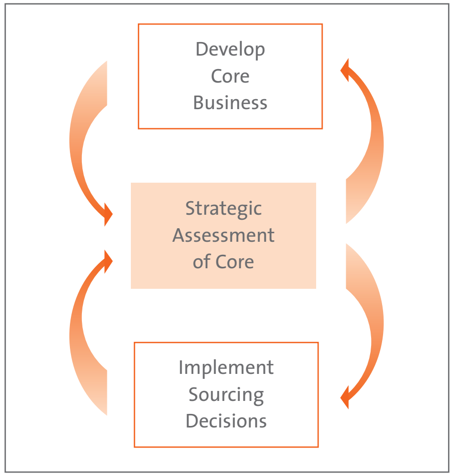

Figure 3: Dynamics of strategic sourcing

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